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Dear Friends

Our major project during the past half year has been researching and writing our report *'The Future of Banking: Reconciling Risk, Profitability and the Public Interest'*. Extracts from the Executive Summary are included in this issue of the Strategist.

As we sought to pull together the various issues involved in today's banking scene – more extensive and intensive regulation, the economic and political climate, and the impact on investor objectives – it became apparent that the fundamental issue is the future of banking as a business. A series of over 30 interviews with our friends in the banking, regulatory, rating, consulting and research fraternities has provided the necessary insights from a variety of constituencies. The report itself was published in September, 2011, and copies can be purchased from our publisher Ann Tierney of *Searching Finance*. We look forward to discussing our findings with you! As our good friend Professor David Llewellyn points out, this future will evolve considerably in the next few years, but at least we have tried to grasp the basic outline!

We also note a birthday for our International Bank Planners Forum, which celebrates its 20th year in 2011. We are most appreciative of the support of our ten bank members and those of you who have attended the program over the years.

Also in the world of banking seminars, we journeyed to Cyprus in October to provide the keynote presentation for the Second Annual Retail Banking Conference in that beautiful country.

Steve Davis

THE FUTURE OF BANKING: RECONCILING RISK, PROFITABILITY AND THE PUBLIC INTEREST

Three years after the implosion of the 2008 financial crisis, the profile of banking is undergoing massive change as governments and regulators seek to avoid the future provision of taxpayer support to failing banks. While the future of many initiatives is unclear, we have used in-depth, off-the-record interviews with 30 veteran observers of the banking scene – regulators and supervisors, the bankers themselves, management consultants, bank analysts and academics – to obtain a composite view on the future of banking after the most traumatic of financial crises since the 1930s.

• **CORPORATE GOVERNANCE**

Our analysis begins with the impact of traditional corporate governance – the checks and balances in any corporate body to allow independent directors to challenge and deflect strategies and initiatives which might endanger the public interest as well as that of stockholders. Our research confirms that such governance in many banks has not been effective, but our interviewees gave little confidence that it would be significantly improved by measures such as now being proposed by the European Union.

Banking has become an extremely complex and fast-moving business, and part-time independent directors (NEDs), often without the necessary detailed knowledge of this business, are perhaps not equipped to do more than note a possible problem. And in the dialogue with a bank CEO determined to pursue a given course, the issue of 'crossing the line' – actually opposing the CEO – the NED often will content himself with assurances that all is well rather than resign or go public with his concerns. Regulators are attempting to de-risk the banking business, but it is difficult to see a transformation which would effectively address this problem.

• **RE-REGULATION**

Thus re-regulation is the focus of efforts to avoid or minimize the impact of future crises on taxpayer resources. The Basel 3 program has introduced liquidity rules as well as substantially increased minimum capital levels, and our research indicates that these initiatives are widely accepted, if not actually welcomed. More concern is expressed on efforts to in effect restructure banks across a diverse global universe. Rather than

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actually break up banks, a number of structural initiatives – Too Big to Fail (TBTF), ring fencing protected activities, and ‘living wills’ – all seek to create structures for failing banks which would minimize the impact of such failure.

Our research indicated great concern from different perspectives over the consequences of imposing such measures across a global banking universe with widely different structures and practices. Quite apart from their possible cost and effectiveness, observers point to unintended consequences such as transferring risk to unregulated non-banks and actually increasing arbitrage opportunities across an unlevel global playing field. The next two years will thus be critical in addressing these untested initiatives.

• IMPACT ON BANK PERFORMANCE

Faced with the new measures already agreed on traditional

benchmarks like additional equity and liquidity rules, bank management has begun to adapt their strategies. Perhaps most importantly, returns on equity (ROE) are widely accepted to fall from perhaps 20% before 2008 to half that level, not far above an assumed cost of equity of roughly 9-10%. Figure 1 provides a projection by Fitch of European bank ROEs through 2012.

Equally important in the present economic and political climate, annual earnings growth is assumed to fall well below the double digit level which both management and investors have targeted. Thus the phrase ‘back to the future’ is often used for bank stocks, referring to the role they played in the 1990s as low growth, dividend-yielding investments before earnings growth and high returns became the mantra during the boom years prior to 2008.

While the phase ‘utility investment’ has now become part

of the banking vocabulary, the managements we interviewed are now focusing on revamping their business model to reduce costs, emphasizing businesses which do not require high levels of regulatory capital, exiting marginally profitable activities, and generally attempting to achieve some earnings growth and returns in excess of the cost of capital. The next few years will thus witness their success in this direction as well as the outcome of the new regulations already agreed and the structural initiatives like TBTF proposed. Figure 2 from Barclays Capital shows how national banking system assets in many countries from 1980 have outperformed national GDP. Yet on balance we found little interest at present in the concept of a ‘utility’ strategy for banks – basically providing a generous and reliable yield on capital with little or no growth.

More specifically, strategic change will be particularly

Figure 1 - Projected ROEs in European Banking

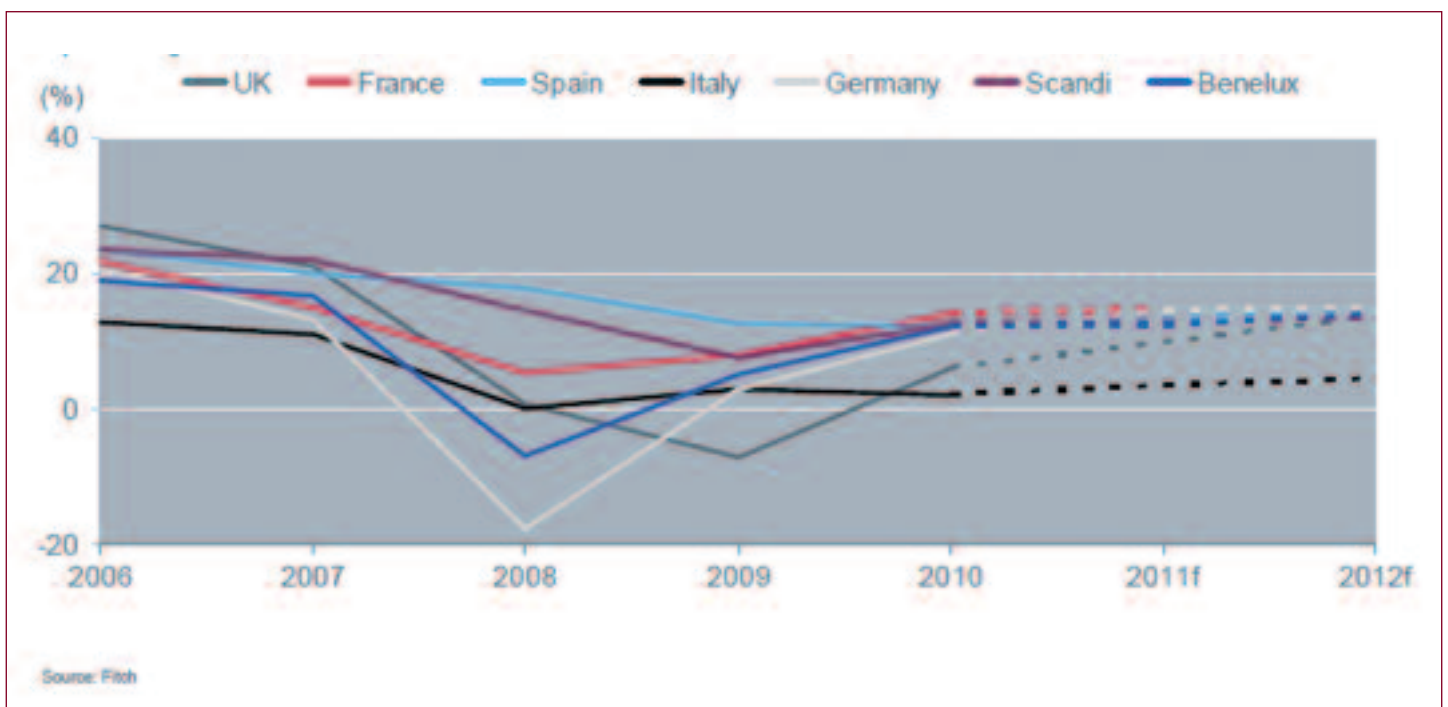
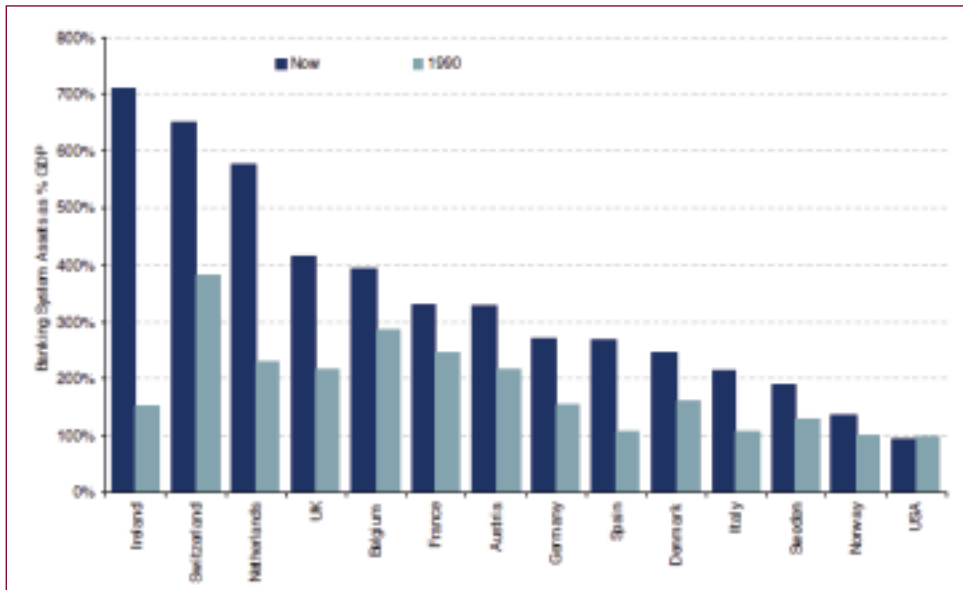


Figure 2 - Growth in Banking System Assets vs. GDP



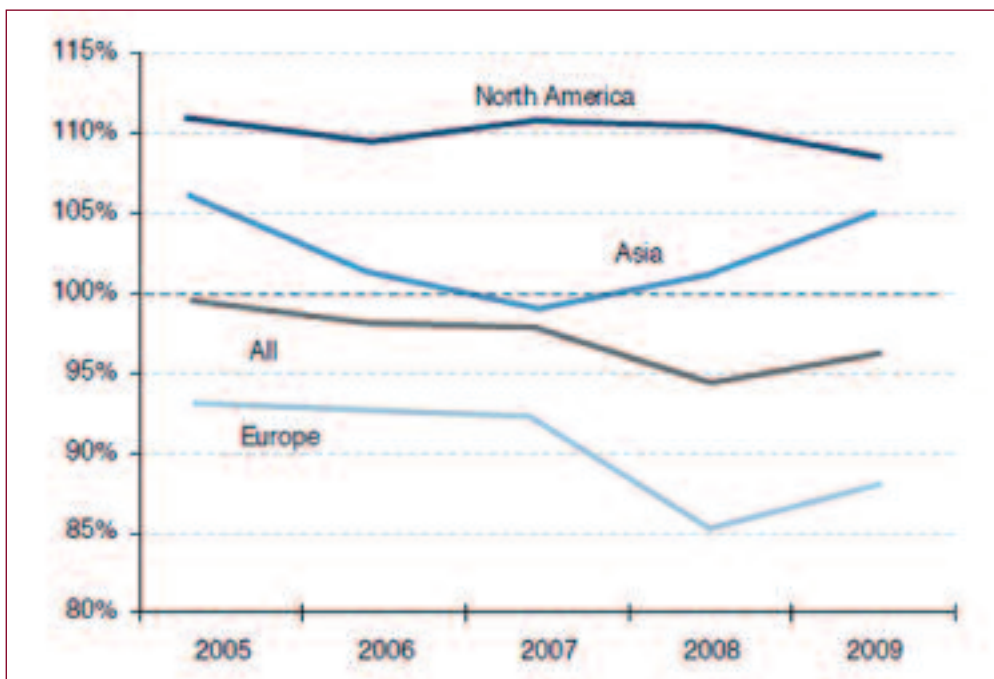
Source: OECD, Barclays Capital, Central Bank websites

dramatic in investment banking, in part because of the decline in customer trading activity but also due to the constraints placed on bank position-taking for its own account and private equity. We expect a variety of different investment banking strategies across the major institutions. In the retail/SME sector, banks will attempt to recoup the revenue losses suffered by regulatory cuts in fee income and product simplification by offering new fee-generating products.

• **OUTLOOK FOR THE FUTURE**

While regulators are focusing on de-risking the banks, clients continue to be attracted by high-risk, high return investments. It can thus be assumed that non-banks will be particularly successful in attracting such business, which raises the obvious issue of the extent of risk transfer in this direction.

Figure 3 - Net Stable Funding Ratio by Region



Source: Bankscope; and IMF staff calculations

The challenge facing regulators in applying the proposed structural changes in a global banking world is a massive one with an uncertain outcome. Politics and economic conditions will undoubtedly play a role. Yet our findings in this and earlier research indicate that supervision by experienced national supervisors prepared to intervene when they detect problems, along the lines of the well-established Pillar 2 of Basel II, can be enormously effective. While such supervision helped avert bank failures in most countries, it was in the US and UK, two major financial centres, where supervision failed in 2008.

The adequacy of bank funding has risen to prominence as well. Figure 3 from Fitch profiles the net stable funding ratio (linking total customer funding to asset base) by region. European banks thus face a real challenge to achieve this 100% coverage proposed by the regulators.

In this context, we profiled the case studies of seven banks (JPMorgan Chase, Svenska Handelsbanken, Wells Fargo, Banco Santander, Toronto Dominion, Standard Chartered

and BNP Paribas) suggested by our interviewees as having succeeded in the past in achieving significant earnings growth and returns while at the same time effectively controlling risk. Such skills will be in short supply in the future world of lower growth and uncertain political and economic conditions.

Our conclusion for the future from this analysis is that a strong, risk-oriented management and client-focussed culture are much

more important than the business model chosen. Diversity of business lines can be a great advantage, particularly in a time of uncertainty. Yet banks like these who have a proven ability to manage risk, but at the same time profit from growth opportunities, in our view will be the winners in whatever banking world emerges from the 2008 crisis. Most of our success stories have been successful acquirers with the ability to manage efficiently such acquisitions.

An invitation to the International Bank Planners' Forum

The International Bank Planners' Forum (IBPF) was formed in 1990 at the instigation of DIBC. The Forum provides an opportunity for key individuals charged with the strategic development of their financial institutions to meet to discuss and debate issues of common interest. The membership consists of leading banking institutions in Europe and the US.

The next meeting is scheduled to take place on Thursday 10th November and Friday 11th November 2011. The Friday session which is open to non-members comprises the following agenda:

- Summary of current trends and issues in banking
Steven I Davis, DIBC
- The view of the bank analyst on today's issues
Stuart Graham, CEO Banks Strategy, AUTONOMOUS Research LLP,
- The challenges facing bankers and bank regulators and the likely outcomes
Professor Peter Hahn, Adviser to the FSA and Professor of Finance at Cass Business School
- The outlook for banks and banking as a result of the crisis and re-regulation
Gerry Rawcliffe, Managing Director and Head of Financial Institutions Research Unit, Fitch Ratings

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